The consequences of European economic and monetary integration for the financial markets and institutions

Eijffinger, S.C.W.; Gerards, J.L.

Published in:
European monetary integration and the financial sector

Publication date:
1993

1 The consequences of European economic and monetary integration for the financial markets and institutions

by Sylvester C.W. Eijffinger and Johan L. Gerards

The purpose of this book is to investigate and analyze *consequences* of European economic and monetary integration for the financial markets and institutions in the European Community (EC). Although the contributions are discussing and evaluating the overall impact of Economic and Monetary Union (EMU) on the financial sector in Europe, special emphasis will be put on the Dutch perspective as well.
In this chapter *general remarks* will be made with respect to the process of economic, financial and monetary integration in the EC and its implications for the European financial markets and institutions. Furthermore, an *overview* will be presented of the individual contributions on the effects of EMU for the macroeconomic environment (Italianer), the fiscal policy (Kremers and Gradus), the monetary policy (Hoogduin and Korteweg), the banking system (Boonstra and De Jong), co-operative banking (De Leeuw), investment funds (Vliegenthart), pension funds (Connolly and Mensonides) and insurance companies (Lommen). The contributions in the book are analytical, empirical and policy-oriented and have an non-technical and pragmatic approach. They focus on a broad-ranging group of financial and monetary economists at ministries of finance and economic affairs, central banks, commercial and co-operative banks, savings and loan institutions, investment and pension funds, life and non-life insurance companies and other financial institutions. The contributions should also be interesting to graduate and post-graduate students at departments of economics of universities and polytechnics.

1 Economic integration

European *economic* integration started actually with the Treaty of Rome (1958) establishing a free trade over between initially six members states. After a transitional period in the 1960s of creating a full customs union, a common agricultural policy and a system of own ressources, the Werner Report (1970) presented a detailed blueprint for the attainment of an EMU in 1978 which was dropped quickly by the collapse of the Bretton Woods system of fixed exchange rates in 1971 and the first oil crisis thereafter. A long period of eurosclerosis followed before the economic integration process was again pushed forward by the White Paper and Single European Act (1985) which embodied the objective of a single market without internal frontiers by the EC member states at the beginning of 1993. The Internal Market Programme specified methods, timetable and detailed measures for the removal of physical, technical and fiscal barriers creating a unified economic area in which persons, goods, services and capital could move freely between member states.[1]

2 Monetary integration

Monetary integration in Europe began with the 'Snake' arrangement (1972) between the EC members states – of which some left the 'Snake' – plus Denmark and Norway, and the creation of the European Monetary Co-operation Fund (1973). However, during the 1970s the process of monetary integration lost its momentum by the divergence of budgetary and monetary policy within the Community. By the establishment of the European Monetary System (EMS) in 1979 creating a mechanism of fixed, but adjustable exchange rates between most EC currencies, European monetary integration was put back on the agenda.[2]

All former EC member states except the United Kingdom – i.e. Belgium and Luxembourg, Denmark, France, Germany, Ireland, Italy and the Netherlands – agreed to participate in the EMS exchange rate mechanism creating a zone of increasing monetary stability, at the same time gradually relaxing capital controls and improving monetary policy coordination. Spain, the United Kingdom and Portugal joined the exchange rate mechanism in respectively 1989, 1990 and 1991. A distinction can be made between three phases of development of the EMS.[3]

The first phase (1979-1982) can be seen as a period of initial orientation which was characterized by frequent and large realigments between the EMS currencies. The second phase (1982-1987) can be regarded as a period of consolidation which culminated in the Basle-Nyborg Accord (1987) with credit lines for intra-marginal interventions. Finally, the third phase (1987-present) can be considered as a period of re-examination, in the light of growing, uneasiness about the 'asymmetry' of the system. As stated in the Delors Report (1989), the EMS has benefited from the role played by the German mark as an 'anchor for participants' monetary and exchange rate policies.[4] This resulted in the asymmetrical functioning of the EMS, i.e. that Germany focused on an target for money growth and the other participants on an target for their currency's exchange rate vis à vis the Deutsche mark. According to the Delors Report, which studied and proposed concrete stages leading towards EMU, the European Council agreed at Madrid (June 1989) to begin stage one of EMU as from 1 July 1990 with the abolishment of capital controls by most member states and the official status for the Committee of Central Bank Governors.

After the Intergovernmental Conference during 1991, the Treaty of Maastricht on Economic and Monetary Union and a Protocol on the Statute of the European System of Central Banks (ESCB) was signed in December 1991.[5] The member states – except the United Kingdom – agreed to start stage two of EMU as from 1 January 1994, together with the establishment of a European Monetary Institute (EMI) as a predecessor of the ESCB, and stage three of EMU as from 1 January 1997 by a majority of member states or as from 1 January 1999 by any group of member states.

The referenda on ratification of the Maastricht Treaty in Denmark and France put heavy pressure on the EMS exchange rate mechanism on 16 September ('Black Wednesday'). The European Council decided at Edinburgh (December 1992) to allow Denmark an exemption to particpate in stage three after its rejection of the Maastricht Treaty. Therefore, it is most likely that Denmark – and also the United Kingdom – will ratify the Treaty.
Nevertheless, the currency crisis on 'Black Wednesday' proved that as long as the convergence of budgetary and monetary policies in Europe is not fully realized, the transitional phase – in particular the second stage – towards EMU has few benefits and many costs.[6] This implies that the possibility of a two-speed integration process is not unlikely with core-EMS countries, such as Germany, France, the Netherlands, Belgium and Luxembourg, moving ahead and the other countries following later. The Maastricht Treaty does not exclude a two-speed approach of EMU.

3 Financial sector

The consequences of European economic and monetary integration for the financial sector will be numerous. First of all, EMU will affect to a large degree the functioning of both national and international financial *markets*: exchange markets, money markets, capital markets, credit markets and other financial markets. Some markets, e.g. the exchange market of EMS currencies, will shrink considerably in the coming years by the increasing exchange rate stability between these currencies. However, other markets, e.g. the government bond market, will become much more homogeneous by the reduction and, ultimately, elimination of exchange rate risk within the group of participating countries. Thereby, the depth and liquidity of these markets will increase notably making them much more attractive for US and Japanese investors.[7]

Furthermore, EMU will influence the policy making of budgetary and monetary *authorities*: ministries of finance (and economic affairs) and central banks. Of course, budgetary and financial policies of ministeries of finance (and economic affairs) will converge gradually by the criteria for budget deficits and government debt, set by the Maastricht Treaty in order to enter stage three. This will also apply to the monetary policies of EC central banks by the criteria for inflation rates and long-term interest rates and the creation of EMI at the start of stage two.
Finally, EMU will severely change the business of financial *institutions:* commercial and co-operative banks, savings and loan institutions, pension and investment funds, insurance companies and other financial institutions.

4 Macroeconomic environment

The contribution by *Italianer* analyzes the impact of EMU on the macroeconomic environment in the Community. After an introduction on the Treaty of Maastricht, the author discusses the conditions on the convergence of economic and monetary performance for the member states to participate in the third stage of EMU. He investigates likely macroeconomic developments in the EC in the run up to 1996 against the background of the EMU objective, and taking the 1992 economic situation as a point of departure. Italianer discusses the convergence criteria embedded in the Maastricht Treaty, the policy measures likely to be taken for their implementation and their possible impact on macroeconomic performance.
Furthermore, he analyses the shaping factors from inside the EC concerning the macroeconomic environment, such as the success of the internal market, the improvement of supply side conditions, the stability on foreign exchange markets, the ratification of the Maastricht Treaty and the future financing of the Community. Next, the author looks at the external shaping factors which might play a role, e.g. the enlargement with the EFTA countries, the development in Eastern Europe and the former Soviet Union and the successful conclusion of the Uruguay Round. Finally, he concludes with a few remarks on possible implications for the Netherlands in particular.

5 Fiscal and monetary policy

In their contribution *Kremers and Gradus* examine the implications of economic and monetary integration in Europe for budgetary and financial policy making in general and, especially, in the Netherlands. After an introduction on the current pattern of public finance, the authors place the present budgetary situation, particularly with regard to the public deficit and debt, in the perspective of the convergence criteria set by the Treaty of Maastricht. They put special emphasis on the Dutch situation and developments.
Further, Kremers and Gradus discuss the prospects and challenges for public deficit and debt during the coming years, paying particular attention to the consequences of EMU.
Moreover, these future developments are analyzed in conjunction with current and prospective aspects of financial and borrowing policy, such as the weighted average maturity of government debt and the prohibition of overdraft facilities or any other type of credit facility with the central bank or other bodies governed by public law as from the second stage of EMU. Also the authors discuss the foreign holdership and the maturity of newly issued government bonds. Finally, they conclude with some remarks regarding budgetary and financial policy in the Netherlands.

The contribution of *Hoogduin and Korteweg* analyzes the consequences of economic and monetary integration for monetary policy making in Europe and, particularly, in the Netherlands. First of all, the authors discuss the conduct of monetary policy during the second stage towards EMU. Although national monetary authorities will remain responsible for policy making, changes in the monetary policy framework are required in preparation for stage three, e.g. the establishment of independent national central banks in all EC countries, the prohibition of direct lending by national central banks to public authorities and the participation of all currencies within the narrow band of the EMS exchange rate mechanism. At the beginning of stage two the EMI will be founded with the task of preparing for a common monetary policy, strengthening the coordination of national monetary policies and facilitating the use of the Ecu. Furhermore, Hoogduin and Korteweg examine the coordination and convergence of national monetary policies and the need for supplementary policies in other areas. They distinguish two models for the coordination of monetary policies: symmetrical and asymmetrical coordination. The convergence of monetary policies will lead to the narrowing down of inflation rates to the level of price stability.
Finally, the implementation of a common monetary policy during the third stage of EMU is discussed by the authors within the framework

of the Statute of the ESCB. They consider the further elaboration of policy principles, the development of adequate monetary statistics and the harmonization of the monetary policy instruments, and make a few concluding remarks on European central banking.

6 Commercial and co-operative banking

Boonstra and De Jong investigate in their contribution the implications of EMU for the banking industry both in the Community as in the Netherlands.

After an introduction on the recent developments in banking, the authors evaluate the effects of the Internal Market Programme and the macroeconomic effects of EMU. Further, they analyze the single currency in the third stage of EMU and its relation to the current basket Ecu. Also, regarding the conversion of national currencies into Ecu a comparison has been made between a 'Big Bang' and a gradual approach and the costs of a dual currency standard are examined. Next, they discuss the microeconomic effects of EMU for the commercial banks and the role of the monetary authorities in that respect.

Moreover, Boonstra and De Jong analyze the implications of stage three of EMU for the financial markets in Europe. Both the money markets and the capital markets are examined.

Furthermore, the authors discuss the relationship between commercial banks and monetary authorities in the third stage. They consider the reporting and administrative procedures set by the banking supervisors, being the national central bank or a separate institution, and the monetary policy making by the ESCB, including the harmonization of monetary instruments, which should lead to a level playing field for European banks. Finally, the authors make some general remarks and conclusions on the possible strategies for banks with regard to EMU.

De Leeuw analyzes the changes for co-operative banking as a consequence of EMU. He emphasis that there is no fundamental difference between commercial banks and co-operative banks regarding at the effects of economic and monetary integration. Otherwise, he states there still is a ideological difference and a difference in functioning of the two kinds of banks. These differences may be important for the future development of co-operative banks. Therefore, the author starts his contribution with a description of the specific aspects of co-operative banking, the differences between co-operative banks and their development from national banks to international operating (wholesale) banks in the 1990s.

De Leeuw mentions that the development of co-operative banks during the twentieth century resulted in a disappearance of the distinc-

tion between co-operative banks and other (commercial) banks when one looks at the day to day banking practice. But the fundamental difference in the ideology of the two types of banks still remain.
Special attention is given to the organizational structure of co-operative banking groups in Europe. In this context, the Dutch so-called system of a cross guarantee differs fundamentally from other European co-operative banking groups. This difference implies that general supervision rules in the Netherlands applies to the co-operative banking system as a whole while supervision rules in other countries mostly apply to all individual local co-operative banks. The latter will – given the small size of local banks – create problems for these banks when rules of the European directives become more stringent. Consequently, the author foresees a substantial change in the way a number of European co-operative banking groups will be organized. He thinks the systems presently used by Rabobank and Crédit Agricole might be leading.
Finally the author foresees a continuation in the process of growth for co-operative banking along several ways. He states that co-operative banks can merge with each ohter and he also sees possibilities for co-operative banks to acquire listed banks as subsidiaries as well.

7 Other financial institutions

Connolly and Mensonides describe the consequences of EMU for pension funds. They start their contribution with an analysis of the growing importance of pension funds against the background of demographic developments in Europe. Furthermore, they give an exhibition of the three most known financial systems for pension funds: Capital Funding, Pay-As-You-Go System and Book Reserve System.
The authors discuss the developments of pension funds in European countries. They emphasize that outside the UK and the Netherlands, the European pension sector is generally less developped, highly regulated, and subject to wide divergence of national practice and policies.
Regarding the composition of pension fund assets, portfolios of most European funds are nowadays dominated by long-term fixed income investments due to a lack of quality information and legislative barriers. However, Connolly and Mensonides expect pension funds will shift investments outside the home market as a consequence of more open capital markets. Besides, they expect by the condition of limiting the government budget deficits and public debt, and for reducing inflation according to the Maastricht Treaty, risk premia in the capital market will deminish. This will lead to lower nominal capital market rates. These lower interest rates, in combination with reduction of

transaction costs on dealer markets, in particular for equities, and the higher return on equities in the long run, will increase equity investment in Europe. They state, however, that the implementation of the Capital Movements Directive and the Pension Directive are necessary elements to facilitate the flow of capital in a more efficient direction.

Vliegenthart's contribution is written from the perspective of an international investor. The author describes how confidence by institutional investors in the progress towards EMU contributed to a convergence of short-term interest rates, exchange rate stability in the EMS area as well as a rapid growth of the private use of the ECU between 1986 and 1992. Since then, doubts have arisen about the ratification of the Maastricht Treaty, the number of member states which will meet the convergence criteria, the effectiveness of the EMS in stage two of EMU, and the prospects of the ECU becoming a common European currency. As a result, stage two of EMU will be characterized by considerable intra-European capital movements and exchange rate tensions.
For investment funds the most important implication of EMU is the creation of one single European financial area. Vliegenthart expects international fixed income funds will profit from lower inflation in the EMU area – mainly through the efforts of an independent European Central Bank – and from greater budgetary discipline by governments which will lead to lower interest rates. However, the unified European market will become less attractive in terms of currency diversification. Also, as a result of the 'no bail-out' rule, public debt may carry a default risk. International equity funds will gain from the creation of a large capital market with a common currency and will gradually shift their portfolios from domestic markets to the international market. Investment funds should profit from the EC Directive for Undertakings for Collective Investments in Transferable Securities, which has not become fully effective yet, due partly to practical and cultural barriers within Europe. However, these barriers will mainly disappear disappear in due time.
In conclusion, the author expects an active interaction between policy-makers and financial markets as well as a lot of volatility of currencies and intra-European capital flows during the second stage of EMU. The ultimate realization of EMU is important for investment funds and other institutional investors, both within and outside Europe. Vliegenthart concludes that Europe is still far away from a really free European market for investment funds.

Lommen focusses her contribution on the potential impact of European integration on the insurance industry. She is particularly concerned with insurance companies in the Netherlands and on their role as institutional investors.

The Dutch insurance branch is characterized by a traditionally very liberal 'normative' supervisory system. The apparent freedom has contributed to a – compared to European standards – sizeable, concentrated and highly competitive, innovative and cheap market. Foreign influence is substantial, but limited in terms of premium income. The Dutch market is characterized by an almost unique distribution system which is mainly based on a network of independent professional intermediaries.
The author states that, in general, the European insurance markets are currently supported by some favourable trends. Overall growth rates exceed average nominal GDP growth consistently because of demographic developments, stringent budget requirements, growing claim consciousness of consumers and increasing attractiveness of insurance products as savings and investment products. In addition, the European integration process creates many new business opportunities. Deregulations, expanding capital and labour mobility and increased welfare throughout Europe underpin future growth.
However, practical results will be perceivable within several years from now. For a long time, the insurance industry, has been one of the least integrated of all markets and has been one of the most closely regulated branches. Lommen expects cultural differences and traditions, and differences in tax and regulatory environment between EC countries to hamper a massive growth of cross-border insurance activities in the near future.
By virtue of the primary function of insurance companies e.g. offering financial protection, extensive savings flow to insurance companies (and pension funds). The pooling of savings has made these institutions a major player throughout the European economies. Traditionally, the investment portfolios of insurance companies are managed in a risk-averse way. However, European integration and the increasing attention currently paid to Asset & Liability Management (ALM) will enforce a change. More diversification of the investment portfolio in terms of risk and geographical distribution is likely. Finally, the author expects this process may contribute to a gradual reshuffling of ownership, away from individuals and banks towards institutional investors.

Notes

1. See also: M. Emerson, M. Aujean, M. Catinat, Ph. Goybet and A. Jacquemin (1988), *The Economics of 1992*, Oxford University Press, Oxford.
2. For an analysis of the EMS exchange rate mechanism: S.C.W. Eijffinger. The relative positions of the currencies within the EMS band of fluctuation: an empirical study, in: D.E. Fair and C. de Boissieu (eds.) (1988), *International Monetary and Financial Integration – The European Dimension*, Martinus Nijhoff Publishers, Dordrecht, pp. 49-74.

3. For a description of these three phases: H. Ungerer (1990), The EMS, 1979-1990, Policies-Evolution-Outlook, *Konjunkturpolitik*, Vol. 36, No. 6, pp. 329-362.
4. See: Committee for the Study of Economic and Monetary Union (1989), *Report on Economic and Monetary Union in the European Community*, Luxembourg, p.12.
5. For an analysis of the Maastricht Treaty and ESCB Statute: D. Gros and N. Thygesen, *European Monetary Integration: from the EMS to EMU*, Longman/St. Martin's Press, London/New York, in particular chapters 12 and 13.
6. See also: S.C.W. Eijffinger, Convergence of Monetary Policies in Europe – Concepts, Targets and Instruments, in: K. Gretschmann (ed) (1993), *Economic and Monetary Union: Implications for National Policy Makers*, Martinus Nijhoff Publishers, Dordrecht.
7. For an analysis of the process of financial integration in the Community: J.J.G. Lemmen and S.C.W. Eijffinger, The Degree of Financial Integration in the European Community, *De Economist*, Vol. 141 (1993), No.2 (forthcoming).